The Federal Report

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

The Month in Washington: October 2007

Congress spent most of the month sharpening its skills at deadlock and impasse, generating much ink and little enacted policy over healthcare through a multi-week showdown on the State Children's Health Insurance Program (SCHIP, known as "Healthy Families" in California) that remains unresolved. Lawmakers continue to work on the numerous appropriations bills that fund the $3 trillion Federal government, now overdue by a month as the Federal fiscal year ends in September. Ways and Means Chairman Charles Rangel (D-NY) captured much of Washington's attention by moving forward with plans for a sweeping tax bill planned for next year. The Government Accountability Office (GAO) released a report saying that public pensions had generally good measures in force for addressing their pension obligations but had not yet devised controls for their escalating long-term health costs.

Issues and Events

Ways & Means to Focus on 401(k), 457, 403(b) Fees

The Ways and Means Committee will hold a hearing on 401(k), 457, and 403(b) fees on October 30, continuing a trend of policymakers paying more attention to the fees associated with ever-spreading defined contribution (DC) plans. In announcing the hearing, the Committee noted that 401(k) plans have more than $2.7 trillion in assets, or 16% of all retirement savings, while 403(b) plans hold some $701 billion and 457 plans $161 billion.

The release also points out the tax expenditure – revenue forgone to support policies through tax preferences, deductions, and credits – as $40 billion for 401(k)'s while 403(b)'s and 457's combined cost the government $52 billion. The five-year grand total for these three DC plans is $561 billion. "As assets in DC plans grow, so does the Federal subsidy for the savings held in these plans. The Committee is charged with the task of ensuring that these Federal tax subsidies are used as intended under the Internal Revenue Code," the release notes.

As the Ways and Means Committee considers massive tax reform as part of ending the Alternative Minimum Tax (AMT), the DC pension tax expenditure is exactly the sort of glaring number that tax staff will examine to see if the law can be mined for "savings." Techniques used in the past to promote fairness in deductions include income caps, lifetime limits, and restrictions on secondary vehicles for the same deduction (such as what was done for deductions for second homes).

The release quotes Chairman Rangel (D-NY) as saying: “This is an important issue for millions of American workers who are being asked to shoulder the cost of saving adequately for their retirement. If we are going to ask our workers to fully take on this level of responsibility, and the Federal government is going to subsidize these efforts, we have a duty to make sure that our Federal dollars are efficiently and effectively working for the benefit of our workers. We need to make sure that these subsidies are being reflected in the account balances of these workers.”

The hearing announcement comes on the heels of findings by the Congressional Research Service (CRS) that large fees can diminish the lifetime return of a 401(k) plan by 26%. The CRS model compared plans with 2% fees versus one with .4% fees and determined that the lower fee plan would end up $93,000 ahead, with closing balances of $356,434 in the low cost plan against $263,663 in the higher fee model.

Rangel’s hearing signals that Ways and Means is inclined to move its own bill on DC plans. A truly comprehensive bill would involve both the Education and Labor Committee to handle rules and disclosures, and the Ways and Means Committee to enforce these rules through the pension qualification system and IRS oversight of plan requirements.

U.S. CEO’s Also Believe They Are Overpaid

A report by the National Association of Corporate Directors (NACD) found that a substantial majority of surveyed corporate CEO’s agree that those in their line of work are overpaid. Barely more than 2% of respondents termed compensation “too low” and about a third said it was “just right.” Outside directors were of a clearer mind, with 80% thinking that CEO’s are overpaid.

As to the causes, the NACD report says that 60% of directors attribute the excessive levels of pay to the lack of reliable metrics to measure CEO performance. In somewhat of a reversing trend, about half said the use of options was not helpful and that incentives need to support improvement in business operations, not just a rise in share price.

The results will contribute to the ongoing discussion of corporate pay, which has been criticized by bolth institutional investors and President George Bush. The report follows information released in mid-month claiming that the top 1% of earners own 21.2% of the nation’s wealth, the highest concentration of wealth in America since the end of World War II.

While there has been a general perception of growing unfairness regarding the compensation of the very top of the American economy, corporate CEO’s have proven very effective at protecting the insular world of board-determined pay plans. A recurring question in this debate has been how to reform the process and who should be empowered to make changes. Even the growing number of independent directors seems not to have been markedly effective in restraining run-away pay, and recent scandals, even at top reputation companies, show how using options to promote pay-for-performance can be routinely manipulated by compensation committees. The lack of a clear alternative continues to be the best protection for the status quo. The House has passed H.R. 1257 in April to give shareholders greater say in executive compensation but a parallel bill on the Senate side has not yet moved through that body.

Maneuvers on Tax Bill Continue

Plans to revamp the tax code in order to spare tens of millions of middle-class Americans from the Alternative Minimum Tax (AMT) appear to have settled on higher taxes for the upper 10% of earners as its main financing mechanism.

As telegraphed by Ways and Means Chairman Rangel (D-NY), the AMT relief bill will also carry a host of tax changes intended to promote fairness, but fairness is often in the eye of the beholder. For example, the wealthiest Americans already pay the vast majority of the taxes and supply-siders argue that taxing success harms the economy – lowering revenue rather than raising it in the longer run.

However, the Ways and Means bill announced October 25 offers a bit of something for everyone. Corporate tax rates fall under the proposal to 30.5% from 35% and many of the changes appear to mostly track the recommendations of Treasury Secretary Hank Paulson, who has also endorsed the "tighten and lower" approach to corporate taxes. Reports indicate that the credit for domestic manufacturing is among those sacrificed for the lower rate while companies would have more difficulty sheltering their foreign subsidiaries from the taxman. A tax change in carried interest payments from capital gains to normal income is included in the overhaul.

On the individual tax front, the bill increases the standard deduction and earned income tax credit (an offset used by the working poor). The "surtax" on the top 10% of taxpayers would kick in at $200,000 but Rangel assured the public that even most of those making $500,000 come out ahead under his proposal. His written statement harkened back to the 1986 tax reform effort when he wrote, "It is my hope that the Bush administration will seize this opportunity as the Reagan administration did 21 years ago, to work with Congress to simplify the tax code and put money back in the pockets of working families."

As we have reported previously, the Rangel initiative currently has the most value as a predictor of what tax reform would look like in 2009 under a Democratic president. The current political climate makes passage of this proposal a non-starter, which Rangel has acknowledged; even a Senate counterpart is considered unlikely at this time. The Rangel plan aims at many tax breaks championed by the White House and President Bush would almost certainly resist taxes on the wealthy on supply-side grounds. Republican reaction was swift and largely predictable, characterizing the initiative as a huge tax increase on Americans that would be counter-productive in a troubled economy.

The AMT, however, is not going away and someone, sometime, will have to scrape together $800 billion to fix it if the Congress adheres to its current rules on spending. As promised, Rangel has assembled a bill where there appears to be more winners than losers, and if some variation of that approach cannot muster the political critical mass to pass, then the solution to the AMT will probably follow the approach suggested by Senate Finance Committee Ranking Member Chuck Grassley (R-IA). He said that Congress could ignore the rules requiring new spending or tax cuts to be offset in order to ease the pain of passing AMT relief.

Senate Committee Passes Sudan Act

The Senate Banking Committee cleared the Sudan Accountability and Divestment Act (an original bill drafted by the Committee but substantially similar to S.1653 and S.831), counterpart to the House measure (H.R. 180) passed at the end of July. Committee Chairman Chris Dodd (D-CT) said: “Two years ago President Bush declared the crimes in Darfur genocide. We have waited too long. I look forward to getting this bill enacted as soon as possible, and to a day when the people of Darfur can again live free of the grinding, relentless violence and misery under which they have suffered for so long.”

Like the House measure, the Senate legislation authorizes States, localities, mutual fund and pension managers to divest from companies linked to “key business sectors” in Sudan and protects them as fiduciaries for doing so. Passage by a wide margin is expected when the bill reaches the Senate floor; a vote has not yet been scheduled.

New SCHIP Bill Clears House, May Also be Vetoed

The SCHIP renewal vetoed on October 3 has been revamped by Congress to address Republican concerns with the bill but the effort appears to have fallen short as few, if any, former foes of the bill have been swayed by the changes.

The new bill caps eligibility at families of four making $62,000 or less, phases out adults now in the program, and clarifies that illegal aliens could not use the program -- changes that respond to Republican criticism of the original bill, which the GOP said covered kids in families up to $83,000 and lacked clarity on adults and illegal immigrants. The new measure, like the old one, still relies on a 61 cent increase in Federal tobacco taxes as its main financing method. SCHIP subsidizes coverage for lower income workers who do not qualify for Medicaid.

The Administration has stuck to its previous points, reiterating concerns that the legislation does not target the poorest of the working poor in families making $41,300 or less and that the bill still encourages shifting from private coverage to government-subsidized coverage (so-called “crowding out”). Congressman Sam Johnson, a senior Republican on the Ways and Means Committee, called the new bill “nothing less than a bunch of baloney."

Ways and Means Health Subcommittee Chairman Pete Stark (D-CA) countered that “The bill before us today answers [GOP] criticisms. Those who vote against today's legislation can only be voting against the government providing health care to poor children who have no other way to get it."

The “Son of SCHIP” legislation passed the House 265-142 on October 25, again failing to muster enough votes to override a veto (and in fact losing two votes compared to the previous version). The President’s aides announced that he would veto this measure as well.

Another point of controversy was the timing of the vote. Many Members from largely Republican Southern California were back home to deal with the natural disaster in their districts, prompting a cry of “dirty pool” from some who saw the scheduling of the vote as exploiting the disaster for political advantage. Speaker Nancy Pelosi’s (D-CA) insistence on having the vote that day, without seeming regard for the wildfire situation in California, infuriated many Republicans, particularly those from the Southwest. Representative Heather Wilson (R-NM) said the timing was "either a terrible mistake or an intentional partisan maneuver. Either way, they're not going to get any more votes" to override the President, meaning that this effort is almost certainly another empty gesture that has no practical effect on healthcare in the United States.

In a related move, Senator Tom Coburn (R-OK) used children’s’ health care as the lever for an embarrassing vote on earmarks. He proposed that $400 million in certain pet projects would not be funded until "all children in the U.S. under the age of 18 years are insured by a private or public health insurance plan." The amendment failed, 68-26. Coburn voted against the SCHIP bill.

California Congressional Delegation

Miller Gets Ball Rolling on Deferred Comp Fees

Congressman George Miller (D-CA/Richmond), Chairman of the House Education and Labor Committee, introduced H.R. 3185 to address Congressional concerns about 401(k) fees and the perceived lack of disclosure to participants. Miller heard testimony on the bill earlier this month, moving the legislation one step closer to markup by his committee. The bill would require additional disclosure from vendors to sponsors and from sponsors to participants. The proposals include a requirement that sponsors periodically include participant-specific information on fees charged and that the benefit statement include starting balance, ending balance, vesting status, contributions, asset allocation and current value by each investment option, changes in asset value over the year, and net yearly return for each asset for the year.

At the earlier hearing, opponents had the most trouble with the provision that essentially guarantees access to a cheap index fund for each participant and criticized the plan overall as overly burdensome on employers. A spokesman for a coalition of employers including the ERISA Industry Committee and the Chamber of Commerce, said, "The requirements of H.R. 3185 for participant fee disclosure are numerous, burdensome, complex, and likely to increase participant confusion rather than enhance participant knowledge.”

As noted elsewhere in this *Federal Report,* Ways and Means Committee Chairman Rangel (D-NY) announced that his committee would also explore the issue of fees on 401(k), 457, and 403(b) funds. Thanks to Chairman Miller's leadership on the issue, it appears that both committees will press for a solution that combines the regulatory and rule approach of the Education and Labor Committee's jurisdiction, with the tax qualification jurisdiction of the Ways and Means Committee.

Related National and Industry News

New Call for International Accounting Standards

Financial Accounting Standards Board (FASB) Chairman Robert Hertz said, the U.S. needs a "national plan" to harmonize global accounting standards, and the Senate Banking Committee explored the issue at a hearing on October 24.

"When you see most of the rest of the world having moved towards the International Financial Reporting Standards (IFRS), the time has come for us to say 'OK, when are we joining them and how do we envisage that occurring?'" Hertz said. FASB and the International Accounting Standards Board (IASB) have explored merging standards for five years. The Securities and Exchange Commission (SEC) has considered allowing filers to use the IASB rules for U.S. disclosure purposes but the proposal is on hold at the moment.

At the hearing before the Senate Banking Subcommittee on Securities, Insurance, and Investment, Senator Chuck Schumer (D-NY) said, "In today's world, where a typical investment often consists of a Russian investor purchasing shares in a Japanese company listed on an American stock exchange, it simply makes no sense to have different auditing standards for different countries. As the trend of globalization continues to accelerate, it is critical that we establish one common language for reporting financial results to investors." He continued, "Last year, only 3 of the top 25 IPOS chose to list in the U.S. We must reverse this trend, and recognizing IFRS is absolutely critical to doing this. When it comes to the way companies balance their books, Wall Street and the rest of the world should be on the same page."

There will likely be no Congressional movement on accounting harmonization until most of the technical experts involved at FASB, the SEC, and other institutions sign off on a plan. Discussions center on preserving what is good about the U.S. standards and not making the merger of the different rules a "race to the bottom."

Frank Offers Mortgage Reform in the Shadow of Subprime Fiasco

Heavily influenced by the turmoil in the subprime mortgage market, House Financial Services Committee Chairman Barney Frank (D-MA) announced legislation to overhaul practices in the housing market on October 22. Frank held a hearing on the bill two days later and hopes to have it on the House floor by mid-November.

H.R. 3915 targets four areas for reform. The bill imposes new duties and registration requirements on loan originators, such as bank loan officers; sets minimum standards for loans, including the condition that borrowers have a "reasonable ability to pay;" extends limited liability to the entities that package these loans into securities for the secondary market; and improves consumer protections for both buyers and renters. These changes aim at banking practices that cosponsor Congressman Brad Miller (D-NC) characterized as "predatory."

At the October 24 hearing, the industry cautioned that the remedies in the bill were inappropriate. The American Bankers' Association (ABA) said that creation of the subprime market has helped numerous people of modest means own their own homes, and that the Frank bill could endanger the health or even existence of that market. Mortgage securitizers are an important part of keeping the process functional and efficient. ABA said that banks already struggle under Federally-imposed paperwork and community banks should not be punished for a subprime lending problem in which very few of them engaged. The industry spokesman also doubted the need for protection of renters in foreclosed property and suggested that it would hamper the ability to return the property to the marketplace. Bankers also complained about the lack of Federal underwriting standards that provide a uniform standard nationwide, pre-empting the States.

The consumer advocacy lobby in turn welcomed the legislation as a means to halt predatory lending and called for tough enforcement of the bill's standards. Brenda Muniz, legislative director of ACORN, said the bill "does a lot of good on the front end" but questioned if "the remedies that are provided in the bill are really significant enough to discourage these kinds of bad actors in the marketplace." The banking industry tends to overpower the consumer side when they clash. However, the depth and potential impact of the subprime lending troubles may have temporarily rebalanced the scales to favor consumers more than in the past.

Sources suggest that banking interests may let the House have its say and work to change the measure in the more moderate Senate, which has not yet advanced a housing reform agenda similar to the House. However, Senate Banking Committee Chairman Chris Dodd (D-CT) reacted to the House Bill with approval and gave his read of the problem: "The problem in the market today is that none of the market players have a stake in the long-term success of the mortgage: brokers get paid on volume; lenders quickly sell off most subprime loans to Wall Street; and Wall Street slices and dices the mortgages into securities and sells them off. They all make their money whether or not the borrower can afford the loan. The homeowner is left holding the bag. Together, strong standards and tough remedies will reward affordable loans and punish predatory lending. In my view, that is the measure of a successful bill, and that is what my bill will do."

SEC Presses on with Shareholder Access Proposal

With its number depleted from retirement and another commissioner set to resign, the Securities and Exchange Commission (SEC) said it will press ahead with the controversial measure of allowing shareholders access to the proxy.

SEC Chairman Chris Cox said the Commission would proceed with the two plans on shareholder access. One essentially prevents any shareholder access to the company proxy, while the other allows groups of 5% ownership held for one year to include their candidates and materials in the official company proxy material. Business groups criticized the second proposal as an invitation to special-interest driven anarchy and waste of corporate assets best spent elsewhere; shareholders denigrated the provision as setting the threshold for proxy inclusion so high as to be effectively meaningless; and departing Commissioner Roel Campos (D) called both plans “awful” and said they should both be scrapped.

Earlier this year, Cox provided the majority vote to approve both plans. The two Republican commissioners supported the exclusionary proposal while the two Democratic commissioners favored the 5% ownership ante plan. Campos left the Commission on October 18 and the other Democrat, Annette Nazareth, has asked not to be reappointed to her position. With the SEC currently at two Republicans, one Democrat, and a Chairman who was a Republican Congressman from California, it seems the smart money favors either the restrictive proposal or a 2-2 deadlock on the pro-investor plan, with Cox providing the tying vote when the Commission considers the matter this November.

Some lawmakers, including House Financial Services Committee Chairman Barney Frank (D-MA) and a substantial number of members from his Committee, do not want the SEC to go forward with the dual proposals without a full five commissioners. In a letter dated October 12, 11 members of the Committee advised keeping the current rules for the coming proxy season.

Some Call Government Plans on Subprime Mess a Bailout

Federal efforts led by Treasury Secretary Hank Paulson to restore order to the commercial paper market smack of a government bailout to some free-market oriented critics. That market has been roiled by defaults in the subprime mortgage industry.

Banks must pay the price for their bad decisions, according to the libertarian Cato Institute’s Chairman William Niskanen. “Like all bailouts, it creates a moral hazard problem. I'm unhappy with situations like these," he said of a plan assembled on October 15 by Paulson to create a fund with Citigroup, Bank of America, and JP Morgan Chase to prop up the troubled asset-backed securities market. The *Wall Street Journal* echoed Cato in an October 16 editorial: “The good news about Monday's announcement that a consortium of big banks is going to try to restore liquidity to the asset-backed commercial paper market with a $100 billion fund is that the effort seems to involve only private capital. The less-good news is that Hank Paulson and the Treasury seem to have gone out of their way to leave their fingerprints on the announced ‘conduit,’ going as far as to talk-up their behind-the-scenes role.”

The Treasury move is in part a response to Congressional criticism that the Administration was not acting forcefully enough to address a difficult, systemic problem in the housing market. In reaction to the deal made with the banks, Senate Banking Committee

Chairman Chris Dodd (D-CT) said: “When I met with Secretary Paulson in August, he pledged to use all the tools at his disposal to help ensure our capital markets function smoothly. Treasury’s effort to organize large financial institutions to ensure the orderly sale of subprime securities may be necessary to prevent a broader crisis in the financial markets, consistent with that pledge. I share the Secretary’s view that our first obligation must be to maintain the orderly operations of the financial system. I await more details about how this unusual effort will operate before saying for certain that it fulfills that obligation. Moreover, the Treasury Department ought to be putting just as much energy into bringing together the large subprime servicers and figuring out how to save the homes of millions of American families threatened with foreclosure as they have done in the effort to protect the financial markets.”

These comments both pro and con can be seen as early placeholders for any debate to come in Congress that does involve public money. Thus far, steps to calm the mortgage market have used the less direct levers of Federal policy through the host of Federally-chartered, and some believe implicitly guaranteed, government sponsored enterprises (GSE’s), such as the Federal Housing Administration (FHA). Action that directly imposes the taxpayer between banks and their mortgage losses could be tougher going; while many “regular people” stand to lose their homes, a great many speculators and house flippers have also been burned in the subprime collapse, and there is little if any sympathy for the later groups.

GAO Positive on Public Pensions, Less so on Health Costs

The Government Accountability Office (GAO) released its long-awaited report on State and local government retiree benefits. The report finds that, in general, public pensions are well-funded and well-managed, and that state and local governments will likely be forced to raise their contribution rates only slightly to meet future pension costs. With regard to retiree health care costs, however, the report confirmed that this was only now really beginning to be addressed as a result of GASB 45’s requirements. Like the broader economy, these costs are rising for public plans far faster than other costs.

The GAO study was requested in July of 2006 by the leaders of the Senate Finance Committee, Senators Chuck Grassley (R-IA) and Max Baucus (D-MT). In requesting the study, the two powerful Senators claimed that the study was needed in order to "help public employees avoid the benefit losses and reduced accruals experienced by their private sector counterparts" and contained a number of troublesome characterizations of public sector funding that led some to believe that they were looking for a report that would serve as the basis for Federal intervention in this area.

Instead, the GAO’s research found a solid public pension system. “Across our site visit locations, we found that state and local governments employ a variety of strategies to keep the funding status of their pension plans on track.” Levels of benefit protection were generally high, with both statutory protection and board oversight of the trust fund. The GAO’s model of fiscal conditions for the long term require less than ½ of a percent increase in government contributions if market returns track their historical record.

Plans did less well in addressing the new issues surrounding retiree health care. GAO found that these benefits had less statutory protection and that those protections that do exist do so as a result of union contracts. There are few strategies in place to handle rising costs, and governments tend to treat them as operating expenses funded on a pay-as-you-go basis. GAO noted that health costs “while not as large a component of state and local government budgets as pensions, will more than double as a percentage of salaries over the next several decades, if these costs continue to be funded on a pay-as-you-go basis” and reminded readers that States will likely also be dealing with increasing costs in Medicaid as their employer health costs also rise.